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In the Supreme Court of the United States

OCTOBER TERM, 1971

RELIANCE ELECTRIC COMPANY, PETITIONER

v.

EMERSON ELECTRIC COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

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OPINIONS BELOW

The opinion of the court of appeals (App. 170–182) is reported at 434 F. 2d 918. The opinion of the district court (App. 157–165) is reported at 306 F. Supp. 588.

JURISDICTION

The judgment of the court of appeals (App. 183) was entered on November 12, 1970. The petition for a writ of certiorari was filed on February 9, 1971, and was granted on April 5, 1971 (401 U.S. 1008). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a corporation may recover, under Section 16(b) of the Securities Exchange Act of 1934, profits realized by a person from a purchase followed within six months by sales of the corporation's stock, where such person becomes a more than 10 percent beneficial owner of the corporation's stock by virtue of the purchase and is a more than 10 percent beneficial owner at any time during the period in which the sale transactions occur.

STATUTE INVOLVED

Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), provides in pertinent part:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner,[1] director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months * * * shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of hold-

[1] The term "such beneficial owner" relates back to Section 16(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(a), which provides for the reporting of beneficial ownership of equity securities and changes in such ownership by, among others, "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12" of the Securities Exchange Act of 1934, 15 U.S.C. 78*l*.

ing the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

STATEMENT

This action was brought by Emerson Electric Company ("Emerson") for a declaratory judgment as to its liability under Section 16(b) of the Securities Exchange Act of 1934 to Reliance Electric Company ("Reliance") for short-swing profits made by Emerson in the purchase and subsequent sale of common stock of Dodge Manufacturing Company ("Dodge"), a company which, subsequent to the purchase and sale transactions, merged into Reliance.

The relevant facts concerning Emerson's purchase and sale of Dodge stock are undisputed. On May 22, 1967, Emerson made a tender offer for shares of

Dodge common stock at $63 per share (App. 15). Upon the expiration of the tender offer, Emerson, on June 16, purchased all 152,282 shares tendered (App. 15). These shares constituted 13.2 percent of the then outstanding common stock of Dodge (App. 17, 157). Until its purchase on June 16, Emerson did not own any shares of Dodge common stock (App. 15).

Prior to Emerson's purchase, Dodge, on June 1, 1967, entered into an agreement with Reliance whereby Dodge was to be merged into Reliance (App. 157–158). Emerson sought to prevent the merger, which needed stockholder approval, advocating instead a merger with Emerson (App. 63). A proxy contest ensued and, at a meeting of Dodge stockholders on August 22, 1967, the Dodge-Reliance merger was approved (App. 64–65).

Following its failure to block the merger, Emerson, on August 28, sold 37,000 shares of its Dodge stock at $68 per share to Goldman, Sachs & Company (App. 16), thereby reducing Emerson's holdings in Dodge to 115,282 shares, which constituted 9.96 percent of the then outstanding common stock (App. 17, 172). Shortly thereafter, negotiations were initiated on behalf of Dodge by Reliance for the purchase of the remaining shares of Dodge stock held by Emerson and on September 11, 1967, an agreement was executed for the sale of the stock at $69 per share (App. 16–17). In accordance with the agreement, the sale was consummated and closed on September 13, 1967 (App. 17). Emerson thus realized substantial profits from the purchase and the sale of both the

37,000 shares and the 115,282 shares of Dodge stock (App. 18). On September 29, 1967, Dodge merged into Reliance (App. 18).

Prior to the first sale of Dodge stock, Emerson's counsel, in a letter dated June 26, 1967 (App. 33–38), had suggested to Emerson alternatives on "how to dispose of, at a profit, the shares of Dodge stock which Emerson now owns" and proposed that Emerson "seek to avoid [Section 16(b)] consequences" through "[t]he initial defensive step" of reducing Emerson's holdings in Dodge to less than 10 percent (App. 36–38).

On February 13, 1968, prompted by a shareholder request that it take appropriate action to recover the profits realized by Emerson on the latter's purchase and sale of Dodge stock (App. 7), Reliance demanded that Emerson account to Reliance for the profits on Emerson's August 28 sale of 37,000 shares of Dodge stock, reserving the right to assert a claim with respect to profits made on the sale of the remaining 115,282 shares (App. 8–9). Faced with this demand, Emerson, on February 29, 1968, brought this action to determine its liability under Section 16(b) for the profits realized on its transactions in Dodge stock (App. 3). Reliance counterclaimed for the profits realized on Emerson's sale of all 152,282 shares of Dodge stock (App. 12).

After a trial on the issue of liability alone, the district court adjudged Emerson liable for the profits realized by it from the sale of all 152,282 shares of Dodge stock (App. 165), notwithstanding the exemp-

tive provision of Section 16(b), which provides in part that "[t]his subsection shall not be construed to cover any transaction where [a more than 10 percent] beneficial owner was not such both at the time of the purchase and sale * * * of the security involved * * *." The district court rejected Emerson's contention that it was not a more than 10 percent beneficial owner at the time of its purchase of 13.2 percent of Dodge stock (App. 158). It concluded that the "at the time of the purchase" requirement of the exemptive provision was satisfied if a shareholder became a more than 10 percent beneficial owner "simultaneously with" the purchase in question (App. 159). With respect to Emerson's profits realized on the second sale of the remaining 115,282 shares, at a time when Emerson was the beneficial owner of only 9.96 percent of Dodge stock, the court found that Emerson's two sale transactions, although "technically separate," were related parts of "a single pre-determined plan of disposition with the overall intent and purpose of avoiding Section 16(b) liability" (App. 163, 164). It concluded that Emerson cannot "excise 16(b) liability or 'avoid its consequences' by utilizing a series of related transactions, some of which considered separately might be exempt, when the obvious substance of the transaction as to a whole is the disposition of its more than 10% beneficial interest," and determined that "the 'time of sale' should include the entire period during which a series of related transactions take place pursuant to a plan by which a 10% beneficial owner disposes of his stock holdings" (App. 164).

On interlocutory appeal pursuant to 28 U.S.C. 1292(b), the court of appeals modified the judgment of the district court. It held Emerson liable for the profits realized on the first sale of Dodge stock, agreeing that the purchase by which one becomes a more than 10 percent beneficial owner is not excluded from Section 16(b) coverage by the exemptive provision (App. 177). It held, however, that Emerson was not liable for the profits on the second sale because the latter "was not made at the time Emerson was a more than 10 percentum stockholder * * *" (App. 182).

Although accepting the finding of the district court that Emerson's two sales were made pursuant to a predetermined plan to dispose of its entire stock holdings with the intent to avoid Section 16(b) liability for the profits realized on the second sale (App. 180), the court below concluded that "intent as such to avoid loss of realized profits by engaging in two independent sales * * * does not result in treating the two sales as one sale of the entire stock held, nor as one continuous transaction * * *" (App. 181–182). It stated that the "standards set forth in Sections 16(a) and 16(b) are arbitrary both in the selection of time, 6 months, and the selection of amount, more than 10 percentum," so that after a sale by which a beneficial owner's holdings are reduced to 10 percent or less "the arbitrary standards * * * are no longer met" and "subsequent sales literally fall within the exemption language of 16(b) * * *" (App. 181).

THE INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

For 37 years, Section 16(b) of the Securities Exchange Act of 1934 has played a major role in implementing the broad aim of Congress "to insure the maintenance of fair and honest markets" in securities transactions (Securities Exchange Act of 1934, Section 2, 15 U.S.C. 78b) by deterring "insiders" of publicly-held corporations—directors, officers and principal stockholders—from unfairly using corporate information to engage in short-swing speculative trading in their corporations' stock and from engaging in activities designed to manipulate the price of that stock. This Court has recognized the particular "prophylactic" effect of Section 16(b), *Blau* v. *Lehman*, 368 U.S. 403, 414, and, in noting the "common origins" of Section 16(b) and Section 249 of the Bankruptcy Act, 11 U.S.C. 649, has indicated that Section 16(b)'s underlying policies require an interpretation of its provisions which will afford a "pervasive and unbending rule against certain forms of insider trading * * *." *Wolf* v. *Weinstein*, 372 U.S. 633, 643 note 11.

The Commission is interested in assuring that judicial interpretation of Section 16(b), like the interpretation of other provisions of the federal securities laws, continues "to make effective the congressional purpose," *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 433, since the private action through which Section 16(b) is enforced complements the Commission's own enforcement actions under the antifraud and anti-manipulative provisions of the federal securities laws.

The Commission believes that the decision of the court of appeals constitutes an unwarranted departure from the principle that federal securities legislation is to be construed "flexibly to effectuate its remedial purposes." *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195.

INTRODUCTION AND SUMMARY

1. The district court, in holding Emerson liable under Section 16(b) for profits realized on both of Emerson's sales of Dodge stock, based its decision upon the finding that Emerson's two sale transactions were related parts of a single predetermined plan of disposition and thus should be treated as one "sale" within the meaning of the exemptive provision of Section 16(b). While we believe that the district court, in imposing liability with respect to both sales, reached the correct result, we are troubled by that court's reasoning. By making Section 16(b) liability turn upon proof that a more than 10 percent beneficial owner acted with a certain intent or state of mind—*i.e.*, that prior to the time the first of the two sale transactions was effected, he had already decided to dispose of all his holdings of the stock—the district court adopted an approach which, to a certain extent, conflicts with the congressional desire that Section 16(b) operate as objectively and automatically as possible.

The objective nature of the elements of a claim for relief under Section 16(b) operates to encourage those persons charged with Section 16(b)'s enforcement—primarily the issuer's security holders—to bring suits under the statute because of a recognition that recov-

ery will come swiftly and without the lengthy trial court proceedings which would result from factual inquiries into an insider's state of mind. In turn, recognition on the part of an insider of the high probability that an action will be instituted for profits he realizes on transactions effected within the six-month period, and that recovery will quickly be secured, contributes to the statutory goal of deterring short-swing trading on the basis of inside information. This deterrent effect which flows from an objective standard of liability would be weakened by the introduction of the district court's subjective test which, because of the difficulty of proving intent or state of mind, would often have the practical effect of foreclosing recovery of profits realized on the second of two sales. It is true that Reliance was able in the present case to prove that Emerson had a predetermined plan of disposition, but this was so because the plan had been outlined in a letter to Emerson by its counsel. It can be readily assumed, however, that a more than 10 percent beneficial owner who seeks to avoid Section 16(b) liability through the technique of effecting two sale transactions, and who knows that the profit realized on the second transaction may be recovered by the issuer only when it can be proved that the second transaction is part of a predetermined plan of disposition, will never again provide the issuer with documentary evidence of his intention.

Were there not an alternative interpretation of the exemptive provision of Section 16(b) which avoids the pitfalls of the district court's opinion,

we would urge acceptance of that court's approach since the exemptive provision should, at the least, not exclude from liability successive sales, within six months after a purchase, pursuant to a predetermined plan of disposition. In our view, however, the purpose and legislative history of Section 16(b) and its exemptive provision give compelling reasons to limit the exemptive provision even further; accordingly, we advance here an interpretation of that provision which avoids the need for subjective inquiries and which would subject Emerson's second sale transaction to liability whether or not Emerson had a predetermined plan of disposition.[2]

2. Our starting point is the legislative history of Section 16(b). Prior to the enactment of the statute, Congress had uncovered many instances where those in control of large corporations had used inside information or had manipulated the affairs of their

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[2] In urging acceptance of the district court's approach as an alternative to the interpretation which we advance in this brief, we point out that the approach adopted by the district court does not go so far as to permit inquiry into whether the insider actually used or intended to use inside information or engaged or intended to engage in manipulative activities. Inquiry into such matters would be squarely in conflict with the congressional intent to adopt an objective standard.

We also note that although the district court found that Emerson's predetermined plan of disposition was, in fact, motivated solely for the purpose of avoiding Section 16(b) liability, its holding that Emerson's two sale transactions should be treated as one "sale" under Section 16(b) does not appear to have been based on the finding of such motivation. It was based only on the finding that Emerson's two sales were effected pursuant to a predetermined plan of disposition.

corporations to profit from short-term speculative trading in their corporations' securities. In enacting Section 16(b), Congress removed the incentive for engaging in such practices by providing that any profits realized by any officer, director or more than 10 percent beneficial owner of a corporation's stock from a purchase and sale or sale and purchase within six months would be recoverable automatically by or on behalf of the corporation irrespective of whether the insider had in fact used inside information or engaged in manipulative activity. The courts have recognized the intent of Congress to curb insider abuses and have broadly interpreted Section 16(b) to effectuate that intent.

Transactions of the type effected by Emerson in the instant case present the potential for the speculative and manipulative abuses which Section 16(b) was designed to prevent. The fact that Emerson was not a more than 10 percent beneficial owner prior to its purchase of Dodge stock but became such a statutory insider simultaneously with such purchase, and the fact that Emerson ceased to be a more than 10 percent beneficial owner prior to the second of its two sales effected within six months of the purchase, do not take the transactions out of the category of insider trading which is capable of abuse. Effectuation of the statute's prophylactic purposes accordingly requires that Section 16(b) liability be imposed on profits made on these transactions.

Turning to an analysis of the provision which exempts from Section 16(b) liability "any transaction

where [a more than 10 percent] beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved," we believe that the provision was not intended to afford a more than 10 percent beneficial owner, who voluntarily attains such status as a result of a purchase of stock of his corporation, a method by which he may structure his sale transactions within the six-month period and thereby avoid liability for a substantial portion of profits realized on such transactions. Rather, as the admittedly scant legislative history of the provision suggests, the exemption was intended to operate in situations where a person purchases stock of a corporation, subsequently becomes a more than 10 percent beneficial owner through circumstances other than a voluntary stock purchase, and then sells his stock within six months of the purchase. Since Emerson became a more than 10 percent beneficial owner as a result of a voluntary stock purchase and lost that status as a result of a voluntary stock sale, the exemption was not intended to be applicable here.

Finally, we believe that the exemptive provision can and should be interpreted to limit its application to those situations to which it was most likely intended to apply. In our view, the words "the * * * sale" in the phrase "both at the time of the purchase and sale" in the exemptive provision encompass a disposition of securities consisting of separate sale transactions occurring over a period of time. Under this construction, if a person was a more than 10 percent beneficial owner

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at any time during the period in which the separate sale transactions occurred, then he had such status "at the time of the * * * sale."

ARGUMENT

A PERSON IS LIABLE UNDER SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR PROFITS REALIZED BY HIM FROM A PURCHASE FOLLOWED WITHIN SIX MONTHS BY SALES OF A CORPORATION'S STOCK, WHERE SUCH PERSON BECOMES A MORE THAN 10 PERCENT BENEFICIAL OWNER OF THE CORPORATION'S STOCK BY VIRTUE OF THE PURCHASE AND IS A MORE THAN 10 PERCENT BENEFICIAL OWNER AT ANY TIME DURING THE PERIOD IN WHICH THE SALE TRANSACTIONS OCCUR

A. EFFECTUATION OF SECTION 16(b)'S PROPHYLACTIC PURPOSES REQUIRES THE STATUTE'S APPLICATION TO ALL OF EMERSON'S TRANSACTIONS IN DODGE STOCK

1. Congress intended Section 16(b) broadly to eliminate profits made by insiders on transactions within a six-month period

In enacting Section 16(b) of the Securities Exchange Act of 1934, Congress sought "to protect the interests of the public against the predatory operations of directors, officers, and principal stockholders of corporations * * *." S. Rep. No. 1455, 73d Cong., 2d Sess., p. 68. The congressional study on which the Act was based had revealed widespread disregard by "corporate managers of [public] companies * * * of their responsibilities as trustees for their corporations," H. Rep. No. 1383, 73d Cong., 2d Sess., p. 13, and had uncovered flagrantly abusive practices by which those in control of large corporate enterprises used inside information to engage in speculative trading in the se-

curities of their corporations for personal profit. These practices were summarized as follows in one of the Committee reports (S. Rep. No. 1455, 73d Cong., 2d Sess., p. 55):

> Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others. * * *[3]

Moreover, Congress found that the possibility that insiders might profit from trading in their corporations' stock led to the deliberate manipulation by insiders of the financial policies of their corporations, without regard for the best interests of the corpora-

[3] The most common examples of abuse cited in the legislative history of the Act were instances where insiders either (1) had bought stock knowing that favorable corporate information was about to be made public and then sold the stock after the market price of the stock had risen following publication of the information or (2) had sold stock with advance notice of unfavorable information and then bought back the stock after publication had depressed the market price of the stock. See S. Rep. No. 1455, 73d Cong., 2d Sess., pp. 55–68; S. Rep. No. 792, 73d Cong., 2d Sess., p. 9.

tion, for the purpose of producing sudden changes in the market price of their stock. See, *e.g.*, S. Rep. No. 792, 73d Cong., 2d Sess., pp. 7–9. As stated by Senator Gore at the hearings which ultimately led to the statute's enactment, "[Section 16(b)] is aimed at the general evil of officers and directors rigging their stock up and down, and squeezing out their own stockholders." Hearings Before the Senate Committee on Banking and Currency pursuant to S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.), 73d Cong., 1st & 2d Sess., p. 6559 (hereinafter "Senate Hearings").

To prevent effectively these and similar practices, Congress in Section 16(b) adopted an objective "rule-of-thumb" prophylaxis, whereby profits realized by a director, officer or more than 10 percent beneficial owner (hereinafter "10 percent beneficial owner")[4] from "any purchase and sale" or "any sale and purchase" of any equity security of his corporation within a period of less than six months are recoverable by or on behalf of the corporation[5] without proof of the

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[4] It was noted at the hearings that ownership of ten percent of a corporation's stock would often result in control of the corporation and thus would be sufficient to enable a person to acquire confidential information. See Senate Hearings, pp. 6556, 7741–7742.

[5] Prior to the enactment of the Securities Acts Amendments of 1964, Public Law 88–467, 88th Cong., 2d Sess., 78 Stat. 565, Section 16(b) was applicable only to corporations whose securities were registered on a national securities exchange. The 1964 amendments enlarged the coverage of Section 16(b) to encompass all companies with securities registered pursuant to Section 12 of the Securities Exchange Act of 1934, 15 U.S.C. 78*l*, thereby including certain companies whose securities are traded in the over-the-counter market.

actual use of inside information or of the existence of a manipulative purpose, or proof that at the time of purchase there was an intention to sell within six months.[6] By adopting the six-month period, Congress sought to avoid adversely affecting long term investment by those who manage and control a company while at the same time discouraging short-swing trading by insiders which Congress found served no useful function, see S. Rep. No. 792, 73d Cong., 2d Sess., p. 6, and which was fraught with the greatest danger of unfair use of inside information and temptation to indulge in manipulative activity.

In short, Section 16(b) was designed to implement a policy seeking to protect the investing public against practices that had caused it great injury. Notwithstanding the fact that recovery under the Section inures to the immediate benefit of the corporation, the statute is intended to ensure the strict observance of

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[6] The need for an objective standard was explained at the hearings by Thomas G. Corcoran, the administration's spokesman for the legislation (Senate Hearings, p. 6557):

"You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing."

The strictness of the provision is somewhat mitigated by the fact that it merely requires the insider to give up "any profit realized" within the six-month period; Section 16(b) does not make it unlawful to engage in purchases and sales within that period. *Petteys* v. *Butler*, 367 F. 2d 528, 532 (C.A. 8), certiorari denied *sub nom. Blau* v. *Petteys*, 385 U.S. 1006. Thus, an insider may recover up to his original investment by selling his stock within the six-month period. Senate Hearings, p. 6557.

corporate insiders' fiduciary duties to other stockholders through the elimination of the incentive which would prompt an insider to engage in manipulative activity or use inside information obtained from his position of trust to trade in the stock of his corporation. See Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess., pp. 85, 132–133 (hereinafter "House Hearings"); Senate Hearings, p. 7742. In turn, Section 16(b)'s deterrent effect is grounded upon an insider's recognition that the statute will be thoroughgoing in requiring disgorgement of profits made on transactions in his corporation's securities occurring within a period of six months.

2. Section 16(b), like other remedial legislation, has been broadly interpreted in order to effectuate the congressional intent

In recognition that Section 16(b) is a remedial measure designed "to squeeze all possible profits out of stock transactions" by insiders, *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231, 239 (C.A. 2), certiorari denied, 320 U.S. 751, and thus to deter the unfair use of inside information, the courts have consistently interpreted the statute broadly and against the insider.[7]

[7] Thus, short-swing trading profits are subject to recovery even though the insider in fact had no inside information (see *Smolowe* v. *Delendo Corp.*, *supra*, 136 F. 2d at 236; *Blau* v. *Lehman*, 286 F. 2d 786, 791 (C.A. 2), affirmed, 368 U.S. 403; *Ferraiolo* v. *Newman*, 259 F. 2d 342, 344 (C.A. 6), certiorari denied, 359 U.S. 927); where a series of transactions within six months has resulted in some profits and some losses, the lowest purchase price has been matched against the highest sales price

As the Second Circuit stated in *Feder* v. *Martin Marietta Corp.*, 406 F. 2d 260, 262, certiorari denied, 396 U.S. 1036:

> The judicial tendency * * * has been to interpret Section 16(b) in ways that are most consistent with the legislative purpose, even departing where necessary from the literal statutory language. * * *

This tendency, of course, is fully consistent with decisions of this Court giving primary emphasis to the congressional purpose underlying a statute, even "sacrificing, if necessary, the literal meaning in order that the purpose may not fail." *Ozawa* v. *United*

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to determine the profits recoverable under Section 16(b) without offsetting the losses (see *Smolowe* v. *Delendo Corp.*, *supra*, 136 F. 2d at 239; *Gratz* v. *Claughton*, 187 F. 2d 46, 49 (C.A. 2), certiorari denied, 341 U.S. 920; *Adler* v. *Klawans*, 267 F. 2d 840, 847–848 (C.A. 2); *Western Auto Supply Company* v. *Gamble-Skogmo, Inc.*, 348 F. 2d 736, 742–743 (C.A. 8), certiorari denied, 382 U.S. 987; *Petteys* v. *Butler*, *supra*, 367 F. 2d at 531–532); the granting of an option by an insider within six months of a purchase has been considered a "sale" within the meaning of Section 16(b) even though the option was not exercised until after the six-month period had run (see *Bershad* v. *McDonough*, 428 F. 2d 693 (C.A. 7), certiorari denied, 400 U.S. 992); and various mergers, exercises of stock options and other transactions have been found to constitute "purchases" or "sales" where necessary to effectuate the purposes underlying Section 16(b) (see, *e.g.*, *Blau* v. *Lehman*, *supra* 286 F. 2d 786; *Blau* v. *Mission Corp.*, 212 F. 2d 77 (C.A. 2), certiorari denied, 347 U.S. 1016; *Newmark* v. *RKO General, Inc.*, 425 F. 2d 348 (C.A. 2), certiorari denied, 400 U.S. 854; *Steinberg* v. *Sharpe*, 95 F. Supp. 32 (S.D.N.Y.), affirmed *per curiam*, 190 F. 2d 82 (C.A. 2); *Blau* v *Hodgkinson*, 100 F Supp. 361 (S.D.N.Y.)).

States, 260 U.S. 178, 194. See also *United States* v. *American Trucking Associations, Inc.*, 310 U.S. 534, 543; *Commissioner of Internal Revenue* v. *Estate of Sternberger*, 348 U.S. 187, 206.

Statutory exemptions to remedial legislation such as the federal securities laws, in the absence of clear proof that Congress intended otherwise, have consistently been construed strictly. See *Spokane & Inland Empire Railroad Co.* v. *United States*, 241 U.S. 344, 350; *Piedmont & Northern Railway Co.* v. *Interstate Commerce Commission*, 286 U.S. 299, 311–312; *McDonald* v. *Thompson*, 305 U.S. 263, 266; *Securities and Exchange Commission* v. *Ralston Purina Co.*, 346 U.S. 119, 126–127; *Securities and Exchange Commission* v. *Sunbeam Gold Mines Co.*, 95 F. 2d 699, 701 (C.A. 9); *Capital Funds, Inc.* v. *Securities and Exchange Commission*, 348 F. 2d 582, 586 (C.A. 8); *Securities and Exchange Commission* v. *Custer Channel Wing Corp.*, 376 F. 2d 675, 678 (C.A. 4), certiorari denied, 389 U.S. 850. The courts have applied this principle in interpreting the provision in Section 16(b) involved in this case, which exempts from coverage

> * * * any transaction where [a more than 10 percent] beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved * * *.

In *Stella* v. *Graham-Paige Motors Corp.*, 232 F. 2d 299 (C.A. 2), certiorari denied, 352 U.S. 831, the Second Circuit sustained the holding of the district court, 104 F. Supp. 957 (S.D.N.Y.), that profits made on a

purchase and sale of securities within six months by a 10 percent beneficial owner who, while not such prior to his purchase, became such as a result of that purchase, were recoverable under Section 16(b). Noting that the legislative purpose would be frustrated were the purchase by which one becomes a 10 percent beneficial owner excluded from the statute's coverage, the district court construed the phrase "at the time of" in the exemption as meaning "simultaneously with" the purchase transaction. *Id.* at 959. In holding that Emerson's purchase of 13.2 percent of Dodge stock made Emerson at the time of that very purchase a 10 percent beneficial owner within the meaning of Section 16(b), the court below followed *Stella* as has virtually every other court that has considered the question (App. 174–179). See *Newmark* v. *RKO General, Inc., supra,* 425 F. 2d at 355–356; *Bershad* v. *McDonough, supra* (alternative basis for liability); *Kahansky* v. *Emerson Radio & Phonograph Corp.,* 184 F. Supp. 90, 94 (S.D.N.Y.); *Abrams v. Occidental Petroleum Corp.,* 323 F. Supp. 570, 579 (S.D.N.Y.), appeal pending; *Simon* v. *Sunasco, Inc.,* CCH Fed. Sec. L. Rep. ¶92,547 (S.D.N.Y.); *Gold* v. *Scurlock,* CCH Fed. Sec. L. Rep. ¶93,021 at 90,771 (E.D.Va.). But see *Arkansas Louisiana Gas Co.* v. *W. R. Stephens Investment Co.,* 141 F. Supp. 841 (W.D. Ark.).

Although the statutory exemption was not directly involved, Section 16(b) has also been held to apply to the purchase and sale by a director who had purchased stock of a company immediately before he became a

director and had sold it at a profit after becoming a director and within six months of the purchase. *Adler* v. *Klawans*, 267 F. 2d 840 (C.A. 2). See *Bershad* v. *McDonough, supra* (alternative basis for liability); *Blau* v. *Allen*, 163 F. Supp. 702 (S.D.N.Y.); *Marquette Cement Manufacturing Co.* v. *Andreas*, 239 F. Supp. 962 (S.D.N.Y.). And in *Feder* v. *Martin Marietta Corp., supra*, purchases by a director were matched against sales made within six months but after the director had resigned. In both *Adler* and *Feder*, the Second Circuit determined that the transactions effected by the respective directors presented the opportunity for abuse of inside information that the statute was designed to prevent.

3. The purchase by which one becomes a 10 percent beneficial owner, followed within six months by two sales, the second of which is made at a time when the seller no longer is a 10 percent beneficial owner, is a series of transactions capable of the insider abuses Section 16(b) was designed to prevent

The insider abuses Section 16(b) was designed to prevent are most readily apparent where the insider—be he officer, director or 10 percent beneficial owner—

is in that status both prior to the first transaction of purchase or sale and after the last sale or purchase. Under such circumstances, the possibility exists that initial purchases or sales can be made on the basis of undisclosed favorable or unfavorable corporate information to be followed by sales or purchases once the market price of the stock has adjusted to public disclosure of the information. As previously discussed (see n. 3, *supra*), this type of trading by insiders—on the basis of *advance* information—was one of the very evils Congress sought to eliminate in enacting Section 16(b). But, as the *Stella, Adler* and *Feder* cases recognized, the potential for abuse also exists where, as in the case of Emerson here, a person becomes a statutory insider simultaneously with or after an initial purchase and loses that status prior to a final sale consummated within six months.[8]

a. There are at least three ways in which the insider abuses sought to be prevented by the statute could

[8] We do not claim that Emerson, in its transactions in Dodge stock, actually used inside information or engaged in manipulative conduct. But that issue is immaterial. For, there cannot be "one rule for insiders with good intentions and another for those who would flagrantly abuse their trust." *Western Auto Supply Co.* v. *Gamble-Skogmo, Inc.*, *supra*, 348 F. 2d at 743. Nor do we claim that Emerson, in fact, had access to inside information or had sufficient control of Dodge to enable Emerson to manipulate Dodge's affairs. The statute makes irrelevant such an inquiry. See nn. 4 and 7, *supra*.

occur where insider status is attained simultaneously with or shortly after an initial purchase. First, a person who becomes a 10 percent beneficial owner as a result of a purchase of a large block of stock may have obtained advance inside information prior to the purchase through negotiations for the purchase with the corporation or a substantial stockholder. In that case, such a person would have been in a position to bargain for disclosures not available to outside stockholders; he could then purchase the stock of the issuer on the basis of the advance information so obtained, and then sell the stock at a profit. Similarly, an officer or director of a corporation may have obtained such information in negotiations prior to accepting the position.

Second, a person may purchase a large block of stock (more than 10 percent) in a corporation in anticipation of engaging in manipulative practices upon becoming an insider which would raise the market price of the stock and enable him to sell his stock at a profit.

Finally, although a person may purchase stock simultaneously with or prior to becoming an insider without any advance inside information or intent to manipulate the corporation's affairs upon becoming an insider, he could nevertheless obtain information or engage in manipulative activity after having become an insider which could be capitalized upon in effect-

ing a subsequent sale of the stock.[9] Such short-swing profit making goes to the core of Section 16(b), which was designed not only to deter the misuse of inside information obtained in advance of an initial purchase, but, as the broad language of the Section's preamble suggests—"For the purpose of preventing the unfair use of information which may have been obtained by * * * [an insider] by reason of his relationship to the issuer" (p. 2, *supra*)— to prevent misuse of such information regardless of whether obtained before or after the initial purchase.

In following *Stella* v. *Graham-Paige Motors Corp., supra*, and its progeny, the court below specifically recognized that the purchase by a previous non-insider of a large block of stock could lead to opportunities to profit from inside information and manipulation and that "deterrence of such apparent potential mischief must have been within the contemplation of Congress" (App. 179). But the court did not make a similar analysis of the potential evils flowing from sales consummated following the termination of insider status.

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[9] The potential for this type of abuse is well illustrated by the *Adler* case where a director purchased stock of the issuer immediately before assuming that position and then sold the stock within six months. The court pointed out that within a week after the director had moved a resolution at a director's meeting that the company purchase 4,800 shares of its own stock on the market, he sold 9,000 shares of his stock. The sale, of course, was effected with the knowledge that the purchases by the company would tend to support the market price in the face of his sale of a substantial amount of the company's stock. By timing his sale to coincide with the company's purchases, he profited from the use of the inside information. *Adler* v. *Klawans*, *supra*, 267 F. 2d at 845–846.

b. The potential for insider abuse does not cease merely because a director resigns or a stockholder reduces his holdings to below 10 percent. A statutory insider may purchase stock on the basis of favorable inside information or pursuant to a manipulative scheme, with the intention of making a short-swing profit on a later sale once the inside information is made public or the manipulative scheme produces a price rise. In either case, the sale is but a vehicle for realizing the profits; its occurrence after the loss of insider status is immaterial. Finally, inside information obtained after a purchase but prior to the loss of insider status may be used unfairly in connection with a sale effected several months after the loss of insider status since the information could continue to be valuable during that short period. See *Feder* v. *Martin Marietta Corp., supra*, 406 F. 2d at 268.

Based on the foregoing, there can be no doubt from a policy point of view that Emerson's transactions in Dodge stock should be subjected to Section 16(b) regulation, in the same manner as liability was imposed in *Stella* and *Adler*, where insider status did not exist prior to the first of the pair of transactions of purchase and sale, and in *Feder*, where insider status had ceased prior to the second of the pair of transactions. If Emerson had made its purchase with the intent to manipulate the affairs of Dodge, both of the sale transactions by which Emerson disposed of its holdings would have been apt vehicles for making short-swing profits once

Emerson's manipulative intent was realized. Moreover, if, upon becoming a 10 percent beneficial owner as a result of its purchase, Emerson had then obtained information by reason of its insider position, both of its sales would have constituted transactions by which such information could have been used to make profits. As previously noted (see n. 8, *supra*), the fact that Emerson may not have actually engaged in manipulation or actually used inside information is irrelevant under Section 16(b).

Notwithstanding the fact that the transactions in the instant case, including the second sale transaction, presented the opportunity for insider abuse, the court below held that Emerson's profit on the second sale was not subject to recovery under Section 16(b). In so holding, the court sanctioned a procedure whereby a 10 percent beneficial owner may engage in short-swing trading in stock of his corporation and be assured of profits with respect to such trading on up to 10 percent of the corporation's outstanding stock which he owns. The ruling below is, therefore, in contravention of Congress' intent to remove profits made on insider trading within six months and seriously undermines the statute's prophylactic effect by providing the very profit incentive which would encourage a 10 percent beneficial owner to use unfairly inside information and engage in manipulative activity.

B. NEITHER THE PURPOSE NOR THE LANGUAGE OF THE EXEMPTIVE PROVISION IN SECTION 16(b) WARRANTS EXCLUDING FROM THE STATUTE'S OPERATION ANY OF EMERSON'S TRANSACTIONS IN DODGE STOCK

In light of the broad congressional purposes underlying the enactment of Section 16(b), the practice of the courts to interpret the statute and its exemptive provision consistently with those purposes, and the fact that transactions such as the ones involved here may be the subject of the very abuses sought to be abolished by Congress, we turn now to an analysis of the provision of Section 16(b) which the court below ruled absolved Emerson of liability for the profits made on its second sale of Dodge stock. That provision, as we have noted, exempts from liability

> * * * any transaction where [a more than 10 percent] beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved * * *.

The court below held that the statute does not reach the profits made on Emerson's second sale because the second sale was not made at a time when Emerson was a 10 percent beneficial owner and the exemptive provision's "arbitrary standards" conditioned liability on a 10 percent beneficial owner being such "both at the time of the purchase and sale" (App. 181–182). The court concluded that the literal language of the exemptive provision required such a result and it was "un-

able to discern from any of the congressional hearings or from the broad basic purpose of 16(b) any intent on the part of Congress not to mean what it has literally said in the 16(b) exclusion clause" (App. 182). In our view, however, neither the language nor the legislative history of the statute requires the result the court of appeals reached; we submit that our interpretation of the exemptive provision better effectuates the policy underlying Section 16(b) than does the interpretation of the court of appeals.

1. The exemptive provision was not intended to preclude liability for profits made on transactions within the six-month period by a 10 percent beneficial owner who acquires such status by a voluntary purchase

The exemptive provision in Section 16(b), by conditioning liability for short-swing profits of a 10 percent beneficial owner—but not the liability of a director or officer—upon his being such "both at the time of the purchase and sale," evidences a legislative intent to treat 10 percent beneficial owners differently from officers and directors. *Feder* v. *Martin Marietta Corp., supra,* 406 F. 2d at 266–267; *Adler* v. *Klawans, supra,* 267 F. 2d at 845. We believe that the different treatment accorded 10 percent beneficial owners was prompted by a recognition that, while officers and directors can only become statutory insiders by voluntarily assuming the position of officer or director of a corporation, a 10 percent beneficial owner may at-

tain or lose such statutory insider status by means other than a voluntary purchase or sale of stock.[10]

A person owning less than 10 percent of the stock of a corporation may have his interest increased to more than that amount through the purchase by the corporation of part of its outstanding securities, partial redemption of stock by the corporation, devise or gift of the corporation's stock, or acquisition of stock incident to service as an executor or trustee or in a similar fiduciary capacity. In many of these instances, the event by which one attains such status would not be subject to his control and, indeed, might even occur without his awareness. Two examples are illustrative:

(1) A, owning no stock of X Corporation, purchases 8 percent of the corporation's stock on January 1. On February 1, X Corporation, without A's knowledge, purchases enough of its stock so that A's percentage of outstanding stock is increased to 11 per-

[10] One court has suggested that the basis for distinction in Section 16(b) between 10 percent beneficial owners on the one hand and officers and directors on the other is that "officers and directors have more ready access to the intimate business secrets of corporations and factors which can affect the real and ultimately the market value of stock than does even so large a stockholder as a '10% beneficial owner.'" *Adler* v. *Klawans*, *supra*, 267 F. 2d at 845. We have found nothing in the legislative history, however, which suggests a congressional belief that large stockholders as a class had any less access to inside information than officers and directors. Indeed, the congressional study on which the Act was based indicates that in almost every instance where speculative and manipulative abuses occurred, large stockholders played a major role in their perpetration. See, *e.g.*, S. Rep. No. 1455, 73d Cong., 2d Sess. 55–68.

cent, thus making him a statutory insider. On March 1, A sells all his stock.

(2) On January 1, B purchases 6 percent of the stock of Y Corporation. Thereafter, on February 1, C, owning 5 percent of Y Corporation's stock, dies, naming B as executor of his estate. As a result, B acquires C's stock, and arguably might thereby be deemed a 10 percent beneficial owner within the meaning of the statute.[11] On March 1, B finds it necessary to

[11] The term "beneficial owner" as used in Section 16 was considered at the hearings to be "the broadest term you can have," Senate Hearings p. 6556, apparently embracing persons owning securities other than record owners who hold *only* bare legal title and who therefore have custody but not control over the securities, as in the case of a nominee. II Loss, *Securities Regulation*, pp. 1100, 1106 (2d ed. 1961). Accordingly, an executor or other fiduciary might be considered as beneficially owning securities held by him in his fiduciary capacity. See Senate Hearings, p. 7235; Feldman and Teberg, *Beneficial Ownership Under Section 16 of the Securities Exchange Act of 1934*, 17 Western Reserve L. Rev. 1054 (1966).

Example 2 set forth in the text assumes that there is a *possibility* that the term "beneficial owner" in Section 16(b) might be construed as requiring that the securities held by the executor in the estate be aggregated with his personal holdings in determining whether he is a 10 percent beneficial owner. We are not suggesting that the statute would necessarily be so construed. Indeed, in the case of securities held by a trustee, an early opinion of the Commission's General Counsel dealing with beneficial ownership under Section 16(a) expressed the view that under certain circumstances the statute does not require such aggregation. Securities Exchange Act Release No. 79 (1935), reprinted in Release No. 1965 (1938), 11 F.R. 10967, 10970–71. But the adoption by the Commission of Rule 16a–4, 17 C.F.R. situations (and also in a separate subdivision, exempting the type of transaction described in example 2) implicitly recognizes that the term "beneficial owner" might be construed as requiring aggregation. We believe that this possibility was among the reasons which led Congress to enact the statutory exemptive provision (see pp. 32–34, *infra*).

sell the stock he holds as executor for the purpose of paying creditors of the estate.

In the absence of the statutory exemptive provision, Section 16(b) might be construed as imposing liability on both A and B for any profits realized on their sales that occurred within six months of their purchases. Liability under the circumstances, however, might be considered inequitable in A's case, because he did not assume the status of a 10 percent beneficial owner voluntarily and indeed was unaware of his status, and in B's case since it would interfere with the performance of his fiduciary obligations as an executor. The exemptive provision would preclude liability in either case since neither A nor B was a 10 percent beneficial owner contemporaneously with his initial purchase.[12]

The admittedly scant legislative history of the exemptive provision suggests that Congress included it to avoid this type of situation. The failure of the initial draft of the statute to contain an exemptive provision[13] was the subject of specific criticism on the grounds of the adverse effect Section 16(b) might have upon the administration of decedents' estates and upon banks acting as trustees or in similar representa-

[12] Congress might also have felt that the risk of insider abuse in many situations where 10 percent beneficial owner status is acquired other than by a voluntary purchase would be significantly less than the risk where such status is attained voluntarily. This would be the case in our first example where A was unaware of his status as a 10 percent stockholder.

[13] Section 15(b) of both S. 2693 and H.R. 7852, 73d Cong., 2d Sess., the first public draft of Section 16(b), did not contain the exemption clause. See Senate Hearings, pp. 6422, 6430; House Hearings, pp. 1, 9. Public hearings were held on S. 2693 and H.R. 7852 by the Senate and House of Representatives, re-

tive capacities. Senate Hearings, pp. 6558, 7226, 7235. The following exchange at the hearings occurred between Senators Kean and Carey and Mr. Corcoran, one of the principal draftsmen of the statute (Senate Hearings, p. 6558; emphasis added):

> Senator CAREY. Suppose this stock passed to an estate, and the estate had to raise money?
>
> Mr. CORCORAN. I do not think, in that case, sir, the statute would apply.
>
> Senator KEAN. Why not?
>
> Senator CAREY. The estate is the beneficiary.
>
> Mr. CORCORAN. I do not believe it would. *Certainly the intention was that it should not apply to that sort of a situation.*

In the light of those circumstances and Mr. Corcoran's statement, Congress presumably added the exemption—which was incorporated into a substitute bill that was introduced in response to "legitimate criticisms" of the original bill made at the hearings (see note 13, *supra*)—to avoid the possibility that Section 16(b) would be applied to those situations.[14]

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spectively, between February 14, 1934, and March 16, 1934. On March 19, 1934, a substitute bill, H.R. 8720, 73d Cong., 2d Sess., was introduced revising provisions in H.R. 7852 in response to "legitimate criticisms" raised at the hearings. House Hearings, pp. 625. Section 15(b) of that substitute bill contained the exemption for 10 percent beneficial owners which now appears in the statute. *Id.* at 637.

[14] If we are correct in our belief that Congress intended the exemptive provision to be limited to situations where 10 percent beneficial owner status is acquired other than by voluntary purchase, then the provision would be similarly limited to situations where such status is lost other than by voluntary sale, since Congress did not differentiate between the two situations.

In short, the exemptive provision of Section 16(b) was designed to avoid liability for changes in 10 percent beneficial owner status resulting from other than a voluntary purchase or sale, and not in situations, like the present one, involving a voluntary assumption of insider status by a purchase and a voluntary relinquishment of that status by a series of sales. We now show that the language of the exemptive provision is capable of a construction which is consistent with that design.

2. The language in the exemptive provision may properly be construed as not excluding from Section 16(b)'s coverage any sale transactions effected within six months after a purchase by which a person becomes a 10 percent beneficial owner where such person is a 10 percent beneficial owner at any time during the period in which the sale transactions occur

The court of appeals, in concluding that the literal language of the exemptive provision excluded Emerson's second sale from Section 16(b)'s coverage, construed the words "the * * * sale" in the phrase "both at the time of the purchase and sale" as meaning a single sale transaction which occurs at a single time. Since Emerson was not a 10 percent beneficial owner at the time of its second sale transaction, the court concluded that that sale was exempt from Section 16(b) coverage.

We submit, however, that in order to effectuate the policy of Section 16(b) to curb insider abuses and in keeping with the settled judicial practice of construing exemptions from remedial legislation narrowly (see p. 20, *supra*), the words "the * * * sale" in the exemptive phrase should be interpreted to encompass a disposition of securities consisting of separate sale trans-

actions occurring over a period of time. Such a construction would have the effect of recognizing only a loss of 10 percent beneficial owner status that stems from an event other than a voluntary sale and would thus be consistent with the probable congressional motive for inserting the exemptive provision (see note 14, *supra*).

To illustrate the construction we urge, consider a person who buys 3,000 shares of stock of a corporation on January 1 and then sells the stock in three blocks of 1,000 shares each during the period April 15 through June 15. While for some purposes, such as the mechanics of delivery and payment, he may be said to have engaged in three separate "sales," he may also be said to have in economic substance engaged in the disposition, or "the * * * sale," of the 3,000 shares. We urge the latter construction for the purpose of applying the exemptive provision of Section 16(b). Thus, if at *any* time during the period in which the three sale transactions occurred he was the beneficial owner of more than 10 percent of the corporation's stock, then he had such status "at the time of the * * * sale."

In the instant case, Emerson was a 10 percent beneficial owner at a time during the period of sale since it was a 10 percent beneficial owner at the time of the first sale transaction. Thus, the conditions necessary for the exemptive provision to operate were not met and accordingly Emerson's second sale transaction should not be excluded from the coverage of Section 16(b).

Although the language of the exemptive provision may be construed otherwise, we believe that our construction best comports with the overall prophylactic

scheme to curb insider abuses embodied in Section 16(b). As the Second Circuit stated in *Adler* v. *Klawans, supra,* 267 F. 2d at 844:

> In addition to the intent and purpose of the legislation which we must glean from the statute as a whole rather than from isolated parts, we must consider the results which would flow from each of the two interpretations contended for. If we find one interpretation tends to carry out and the other to defeat the purposes of the statute, the resolution of the issue becomes simple.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed in so far as it exonerates Emerson from liability under Section 16(b) for the profits realized upon its second sale of Dodge stock.

Respectfully submitted.

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